Oil Valuation Workshop
Albuquerque, 3-25-99

I. Introduction/Opening Statements

Lucy Querques Denett

- brief report from 2-24-99 Houston Workshop
- introductions
- meeting minutes to be put on MMS homepage
- agenda
  - -- order changed from yesterday--focus first on areas we didn't get to (second guessing, location/quality adjustments)
- remarks from States?

Mike Geesey, Wyoming

- thinks Wyoming's position pretty much known concerning RIK and benchmarking in Wyoming

Valdean Severson, New Mexico

- no formal statement; represents his opinion, not necessarily that of Governor

Fred Hagemeyer, Marathon

- constructive dialogue yesterday
- hoping some industry suggestions can help move process forward/not easy task to get consensus among companies/noted there are items to work on form 3/24 mtg. to prepare for 4/6 Washington mtg.
- Oil Valuation Overview (see handout)
- industry proposals tried to work around some of the areas where agreement may be more difficult (e.g., duty to market) in order to get to a solution
- noted linkages between the different issues
  - -- "affiliate" definition linked to other areas
  - -- "gross proceeds" affects other areas
  - -- binding determinations affect other areas
  - -- no second guessing can help in other areas

II. Discussion of Key Issues

1. Second guessing

Lucy Querques Denett

- Summarized 3/24 agenda and turned topic of "second guessing" over to industry

David Blackmon, Burlington

- Unfortunately some of the experts on this issue had conflicts and could not make it today.

Sara Tays, Exxon

- still want the "no second guessing" language fixed in the rule and will make some proposals. Industry's position on this apparently was not clear to MMS based on Armstrong's August 31, 1998, letter.

Valdean Severson

- Wanted to know how proposed rule differed from present one

Sara Tays

- Didn't think "no second guessing" language in proposed rule solved industry's problems
- Don't want to obliterate standards for good faith and fraud; looking instead at greater certainty.
- Look at definition of "gross proceeds" in Feb. 6, 1998 proposed rule
  - -- no longer mentions gross proceeds accruing to <u>just</u> the lessee, but to those <u>accruing</u>; gross proceeds includes services performed at no cost to government
  - -- in preamble of proposed rule, there are examples of services performed at no cost to lessor--recommends removing this list since one of the items (marketing costs) is in litigation, though not disputing the others (which are in the current rule).

Peter Schaumberg

- Surprised that industry disputes that there is a duty to market–there is such a duty, but the disagreement is over how far that duty extends.

Chip Rothschild, Marathon

- agrees that there is a duty to market; disagreement is how far must lessee go beyond lease at no cost to lessor?
- real issue is whether there is a duty to market extending beyond the lease (does lessee breach its duty if it sells at the lease? If a purchaser resells the production, lessee doesn't want MMS to say a higher resale value applies.)

Peter Schaumberg

- Has MMS ever suggested that the lessee has a duty to sell the oil downstream of the lease?

Chip Rothschild

- No, but concerned that a logical extension of defining duty to market as MMS seeks to do would be to say lessee violates its duty to market if it could have received a higher price by marketing further downstream.

George Butler

- existing rules (30 CFR 206.102(b)(1)(i)) say gross proceeds usually used if arm's-length contract applies, but must be increased to the extent that they have been reduced because others perform services that ordinarily would be the responsibility of the lessee to place the oil in marketable condition (206.102(i)). Proposed language (206.106) says that the gross proceeds will be increased to the extent that the purchaser or any other person provides certain services. Old rule only increased gross proceeds if the price was reduced for the service, whereas new rule increases gross proceeds if any other person performs the services. Concern that someone who purchases lessee's oil with no reduction in price could later resell at a higher price and, if the reseller performed any services downstream of the lessee's original sales point, MMS could argue that gross proceeds should be increased corresponding to the costs of those additional services.

Lucy Querques Denett

- Our intention was not to change the meaning of the current language, so we may be able to fix this.

Peter Schaumberg

- This provision always has been, and is still, intended to address situations where the price was reduced because the purchaser takes on duties of the lessee or the lessee pays someone to perform services that are duties of the lessee (and deducts from the price).

Sara Tays

- old rule talks about marketable condition, but new rule adds duty to market the oil. Looks like MMS might second guess arm's-length marketing decisions.

David Blackmon

- Thinks solution is to separate duty to market from marketable condition. Independents want to be sure that if they sell arm's-length at the lease to someone who performs subsequent marketing functions, MMS will not second guess their decision to sell at the lease. They don't know what subsequent services might cost, or whether they might be held liable for additional amounts.

Peter Schaumberg

- MMS wanted to clarify situation in the aftermath of the FERC 636 rulemaking and the IBLA decision in Walter Oil and Gas.
- Preamble to 636 reg. addressed situation where lessee's contract was 98% of index value; lessee took reduced price because it wasn't performing function it was required to, so royalty value must be increased by the other 2%.
- Wanted to clarify that marketing is one of the functions a lessee is expected to perform.
- Wrote chart showing the following:
  - -- offshore lease, market at the lease, sells at the platform for $20.00 (MMS accepts as value)
  - -- pipeline to shore, arm's length transportation charge of $1.00, sells onshore at $21.10, owes royalty on $20.10
  - -- second possibilty that lessee owns the pipeline, actual cost of $.80, owes royalty on $20.30
- Point was that MMS will not second-guess lessees' election whether to sell at the lease, if there is a market at the lease, or to sell onshore.
- But once lessee decides where it is going to market the oil, we do not allow deduction of marketing costs (or difference in value).
- Then asked what <u>is</u> the marketing cost?

John Munsch/David Blackmon

- Selling onshore is more costly than selling at the lease; marketing costs quite different..
- Industry takes more risk by engaging in selling at market center.
- If you market at the lease, industry does not think there should be a deduction for marketing costs.
- But companies do not have to engage in the costs and risks of marketing downstream. Companies can decide whether or not to do this.
- MMS should adjust royalties to acknowledge additional costs to market away from the lease.

Peter Schaumberg

- Is there a way of quantifying those costs?

Debbie Gibbs Tschudy/David Blackmon

- IPAA previously did a survey showing $.07 - $.15/bbl as range of marketing costs.

Peter Schaumberg

- Reiterated that MMS doesn't want to second-guess industry decisions–is "along for the ride"

Chip Rothschild

- Industry has people on duty for rescheduling transportation and other related tasks that should be allowable deductions.

Debbie Gibbs Tschudy

- MMS may consider some such items to be transportation costs (not marketing).
- Many of the items on the list that IPAA provided last year might be transportation (O&M) costs.

Bruce Frederick/Fred Hagemeyer

- Discussed line fill and other tasks involved in marketing

Debbie Gibbs Tschudy

- Much of this might be considered transportation

Chip Rothschild

- what is defined as a market at the lease?

Debbie Gibbs Tschudy

- As long as arm's-length sales occur at lease, there is a market at the lease--if move to market, get transportation deduction

Peter Schaumberg

- There is a market at the lease when anyone is willing to buy it there at arm's length.
- Some early cases dealt with this issue; IBLA has said you can sell anything if the price is low enough, but in some situations there really is not a market. In our experience, duty to market concerns occur only rarely.

Fred Hagemeyer

- Concerned that words in proposed rule could be interpreted overly broadly.

Peter Schaumberg

- It would be helpful to clarify our intentions in the preamble by providing some examples–what we are and aren't trying to get at.

Sara Tays

- But we need to address the regulatory language as well.
- For example, look at 7/98 MMS proposal at 206.102(c): OK with (i) and first part of (ii)--but concerned with last sentence of (ii): "It will apply only when a lessee or its affiliate inappropriately sells its oil at a price substantially below value."

Peter Schaumberg

- Our intent was to look at cases where the price is way below the average and there was something inappropriate going on (e.g., looks like some side deal or a sale to a relative).

David Blackmon

- Needs clarification for future.

Sarah Tays

- Would strike last sentence ("... apply only when lessee...inappropriately...substantially below value"), since if someone did what Peter referred to, the good-faith standard would cover it.

David Blackmon

- And preamble example would be helpful too.

John Northington

- MMS agreed after the Senate meetings in 1998 to take this sentence out and leave language like in the old rule but to include some explanation in the preamble.

Action item to delete the sentence and clarify preamble/add examples.

Peter Schaumberg

- Reiterated that this wasn't intended as change from existing practice

Steve Dilsaver

- Auditors have "healthy skepticism". But if situation is arm's length, there's no need to look further.

George Butler

- MMS reengineering project is seeking to develop marketing/value expertise on field or area basis. MMS is using this information to calculate expected values on field by field basis and will adjust its audit strategy to increase chances of audit where value falls outside expected range.

Lucy Querques Denett

- True–method to target audits. But there's no guarantee an order or bill would result. They probably would ask for a copy of the contract--not an assumption that the company breached its duty to market.

Steve Dilsaver/Valdean Severson

- It's a risk assessment and targeting strategy.

George Butler

- Concerned that auditors might look at situation with low price and find that the purchaser has performed additional services to market downstream of the lease and that MMS would want to add these to gross proceeds (since we don't have the "reduced" language anymore.)

Peter Schaumberg

- We can fix that concern. (Action item added to chart.)

Sara Tays

- It was the combination of these elements together ("substantially below" and " inappropriately")that heightened the concern.
- Also looked at 206.102(d)(3) in Feb. 6, 1998 proposal and found a concern–highest price the seller can receive.
- Would prefer going back to old language.
- Also suggests moving tracing methods to non-arm's-length section.

Lucy Querques Denett

- But tracing involves arm's-length situations.

Debbie Gibbs Tschudy

- Changed for plain language and to reflect that the seller may not be the lessee; wanted to make rules “corporate structure neutral”.

Fred Hagemeyer

- Term “seller” is too broad.

Peter Schaumberg

- Trying to clarify that the rules are corporate structure neutral. We will look at first arm’s length sale in the market.
- Perhaps could clarify by saying “lessee or its affiliate” or by defining “seller.” (Seemed to be general agreement).
- But can’t go back to old language because of plain language principles.
- Action item for industry to try to write something (on the chart).

Sara Tays

- Suggested action items on flip chart for proposed rewrites to 206.102; also suggested changing preamble to clarify that arm’s-length transactions should be compared against other arm’s-length transactions and not against the “formula.”

David Blackmon

- Independents just want to know that their arm’s-length sales in good faith will be accepted for royalty purposes.
- Changed saying no right to look at the contract to make sure there is no fraud.

Valdean Severson

- Noted that we’ll never be able to totally remove suspicion. Will always be some auditors who question specific documents.

George Butler

- Just want to remove room for regulations to be reinterpreted in the future.
- Question on gross proceeds. Proposal has two “buckets”--arm’s length and non-arm’s-length.
  - -- gross proceeds w/o second guessing for oil sold arm’s length
  - -- oil that is refined clearly falls into non-arm’s length category
  - -- But for oil sold to an affiliate who then sold at arm’s length, lessee has the choice under current proposal of index or tracing. (Industry would add comparables.)

But thinks that buy/sells and exchange agreements are different. If production goes through an arm's-length exchange, does MMS provide option for tracing/index? .

Debbie Gibbs Tschudy

- Yes, agrees to interpretation.
- You're trying to classify into arm's length and non-arm's-length "buckets"–clarify under 102 bucket that if you sell arm's length after arm's-length exchange or buy/sell agreement, then you have the choice of index or tracing proceeds.

George Butler

- Where does lessee have option for tracing/index? That's the concern; tracing may be difficult.

Debbie Gibbs Tschudy -

- Index can then be used.

George Butler

- Industry would advocate that its comparable sales proposal would apply to exchanges and transfers to affiliates (even though some of them may be under the "arm's length" prong of the rules).

Debbie Gibbs Tschudy
- If we accepted comparability proposal, it would go into §206.103, and the types of transactions George is referring to would end up being valued under that section.

Sara Tays

- Suggested having independents provide examples for use in preamble.

Peter Schaumberg

- Discussion of Walter Oil and Gas IBLA decision: concluded that lessee could choose marketing methods, but can't deduct costs performed by another on its behalf. Lessee may choose to use its own personnel or hire someone to perform marketing functions. Cannot deduct the costs in either case.
- Discussion of paper by Geoffrey Heath from October 1998 PDI conference.
  - -- Taylor Energy IBLA case. Reseller sold production for 3% commission. Duty to perform marketing and cannot deduct the fee. Board held that resale price represented that which Taylor should have received, with no cost to lessor.
  - -- Amoco IBLA decision--third-party contract deducting marketing costs results in adding deducted costs back to the gross proceeds.

- These cases say that it's lessee's duty to market at no cost to the lessor. Our intention was to clarify in the regulations that the types of costs we would add back to gross proceeds is not just marketable condition costs but also marketing costs.

Fred Hagemeyer

- That's the essence of the debate on duty to market.

George Butler

- Agreed. The way the issue is characterized goes a long way toward ultimate resolution.
- Concern is that lessee tries to get the best deal out there and then MMS may come in for more royalties.

Peter Schaumberg

- We are simply saying that if the lessee is going to perform marketing downstream of the lease, or have someone else do it, then they can't deduct the cost of marketing.
- Clear break at the lease is something we will accept, but if lessee goes downstream, then so do we.

George Butler/Sara Tays

- Concern is that the lessee incurs some risk downstream. It's a way for MMS to get higher value, but wants MMS to participate in the risks.

Sara Tays

- Anomalous result that MMS treats people differently based on different ways they choose to market the oil.

Peter Schaumberg

- Distinction is we will share in ups and downs resulting from marketing decisions.

Fred Hagemeyer

- Wanted to clarify that rules now don't require duty to market. (Peter Schaumberg agreed, based on IBLA decisions/interpretations.).

- If lessee hired someone to perform bid-out process at the lease, then could see why MMS might not allow the deduction.
- But don't see why MMS would not allow the deduction if the lessee pays someone to market downstream from the lease.

Peter Schaumberg

- Essence of position is that if lessee incurs marketing costs, we don't think they should be deducted.
- Consider situation where company used its own staff to market onshore. MMS allows no deduction.
- So shouldn't allow deduction when company pays someone to do it rather than do it internally.
- Litigation on FERC 636 may provide further clarification–if marketing, no deduction, if transportation, is deductible. But we are seeking just to codify the precedent of IBLA decisions.

Chip Rothschild

- Note that discussion here does not mean that industry acquiesces in the IBLA decisions discussed.

2. Definition of Affiliate

George Butler (see handout)

- Armstrong Letter to Breaux–would return to existing affiliate definition. MMS working on guidelines for rebutting presumption of control
- Structure of market has changed with many new alliances where the corporation does not really control the affiliate
- E.g., Chevron gas sold to Dynegy, in which Chevron has 25% interest.
- Chevron does not control the affiliate but has duty to rebut the presumption of control (prove a negative).
- Standards for rebutting presumption of control should be put into regulations (not guidelines). Should be subject to comment.
- Proposed standards in handout. For situations of ownership of 10%-50%, the presumption of control would be rebutted if:
  - -- affiliated entity can take any relevant action w/o affirmative vote of lessee
  - -- lessee is a limited partner rather than a general partner
  - -- lessee is a natural person not related to the fourth degree with the affiliated natural person, then no control
  - -- lessee's directors on board of affiliated company cannot block any relevant action of the affiliated company, then no control through interlocking directorates

Chip Rothschild

- The limited partnership concept, however, would be subject to the 50% criterion; if the limited partner owned more than 50%, there would be control.

Debbie Gibbs Tschudy

- Do guidelines apply only to affiliation/control, and not opposing economic interests?
- Notes that there are two separate standards. Discussion of Xeno situation in preamble to rule where there was no opposing economic interest even though no control.

George Butler

- If presumption of control is rebutted, then there would be opposing economic interests–if demonstrate no affiliation, should be considered arm's length sale.

Bruce Frederick

- Why not just use opposing economic interests, rather than adding the control concept?

George Butler

- Problem for industry is that the burden is on industry to rebut a presumption of control.
- Questioned how someone could say there aren't opposing economic interests when the lessee sells at the market price or better. Can we articulate in a rule what opposing economic interests are without establishing an insurmountable hurdle for industry?

Peter Schaumberg

- MMS understands that there are various corporate and tax reasons for setting up business and transactions in certain circumstances. But described overall concern of profit centers within companies and concerns over related industry intent for royalty payment purposes.
- The Department doesn't want to get into these issues, so if we see a situation where it is not clear that the transaction is arm's length, then we want to treat it as non-arm's-length.

George Butler

- Again, rebutting a presumption of control is proving a negative.

Debbie Gibbs Tschudy

- Noted that MMS has had to sue to get some affiliate documents–wants to avoid as many such problems in future as possible.

George Butler

- Need way to make sure that presumption of control rebutted–to make sure that given transactions would be considered arm's length.

Debbie Gibbs Tschudy

- Reiterated that opposing economic interests would have to be shown in addition to control issue.

George Butler

- Can we define opposing economic interests? Also, not aware of any cases where anyone has rebutted presumption of control where ownership between 10 and 50%.

Peter Schaumberg

- True, but there have been few such cases at issue.

Sara Tays

- Perhaps few because criteria seem insurmountable? Important to give good guidelines, especially given other rule changes and emphasis on ways to deal with non-arm's-length situations (e.g., transportation).

Debbie Gibbs Tschudy

- We committed to look at industry's proposed standards on defining affiliate and consider together with our ideas.

George Butler

- There should be an action item to look at opposing economic interest criteria.
- Can't there be circumstances where, for example, 2 family members have opposing economic interests? (Peter Schaumberg: Explain in corporate context?) For example, Chevron owns 25% of Dynegy, which isn't related to Chevron–it's a joint venture.

Peter Schaumberg

- Note that we are going to apply a pretty tough standard.

Fred Hagemeyer

- In joint ventures, the various third parties involved may have no say in the joint venture decisions, and the economic interests between the affiliates is likely to be opposing.

Peter Schaumberg

- There are many different types of joint ventures, and we may view them differently. For

example, a case where production (and marketing costs) is aggregated and the lessee shares proportionately in the proceeds may be viewed differently than where a company buys into a joint venture buying from multiple sources. Where the lessee owns a minority share but provides its ownership share of production to the entity and reaps a proportional share of the profits, then we might find the economic interests are not opposed.

Action item for MMS to come up with some examples of situations where economic interests are not opposed and industry to come up with examples of different types of joint ventures and varying levels of control.

Bruce Frederick

- Noted that opposing economic interests is an inherently factual inquiry for which it will be difficult to develop specific criteria.

3. Non-Arm's Length Transactions

Fred Hagemeyer (see handout on comparable sales model)

- Trying to deal with demonstrating comparables.
- Industry wants to build on the MMS proposal for benchmarking in the Rockies.
- Noted that in yesterday's Houston meeting we discussed whether arm's-length sales away from the lease, rather than just those at the lease, should be included.
- Burden on lessee--if they pass certain tests, they can use the comparable sales model:
  - -- 20% of lessee's production sold/purchased arm's length within comparable production area (action item from Houston to think further about the percentage)
  - -- industry would have to have data and contracts to back up their claim of 20% arm's length sales; spreadsheet to be available for MMS review.
  - -- minimum number of 3 bids for bid out programs
  - -- use weighted average prices
  - -- adjustments for quality and transportation as necessary
  - -- annual review by MMS (e.g., know what production areas to look at). Review would help to avoid situations where problems are found years later.
- Industry thinks this has benefits compared with current benchmarks as well as compared to index prices.
  - -- captures value at the lease and avoids need to calculate differentials/transportation.
  - -- different players in the lease market then the market center market
  - -- RIK programs have provided some experience showing that there is a market at the lease
  - -- simplifies audit/focuses on simplified spreadsheets.
- some lessees may want to do this, but others may choose not to.

- Industry has made concessions:
  - -- stricter qualifications for participation
  - -- industry record keeping

Valdean Severson

- How was 20% derived?

Fred Hagemeyer

- Once you determine what the comparable field/area is, the lessee's total production in the area is the denominator and the lessee's arm's length sales and purchases from the area would be the numerator.
- Would not include sales to affiliates, but would include affiliates' 3rd-party sales and purchases.

Debbie Gibbs Tschudy

- Yesterday lots of discussion of proper percentage to ensure company has production at risk.
- MMS committed to look again at combination of royalty rates and severance tax rates by State.

Sara Tays

- The lessee and its affiliate(s) both could be active in the third-party market.

Debbie Gibbs Tschudy

- For Valdean Severson: Are you comfortable with industry's approach?

Valdean Severson

- No; thinks index netback is better. Might be more comfortable if the percentage were 50 rather than 20.
- Note that in NM most production is marginal so no severance tax.

Bruce Frederick

- General concept is OK; comparables represent classic valuation method. But problem is determining what is arm's length.

George Butler

- Problems w/ index-we're talking about production not sold. If use a downstream price, must value as if actually sold there, but can't deduct marketing costs. Implies duty to market downstream.

Bruce Frederick

- Not a requirement to market downstream, but just a way to netback a price at the lease.

Lucy Querques Denett

- Yesterday we discussed tendering programs and possibility of creating a market artificially where there was not a market otherwise.

Jason Doughty

- Why wouldn't tendering represent fair market value?

Peter Schaumberg

- Concern that market was artificially created and may not represent the range of prices in the market.

Debbie Gibbs Tschudy

- And if only a small volume tendered, there may be limited interest in getting the best price.

George Butler

- Why is index netback preferable when you're not selling at the market center? Seems cynical to allow only transportation deductions as if you did sell oil at the market center.

Valdean Severson

- Note that doesn't just apply to people who refine oil; could also apply to others who buy and sell but do not refine.

George Butler

- If such parties don't want to use comparables method, could go to index or trace production under the industry proposal.

Sara Tays

- Best proxy for the market is the sales at the lease.
- RIK programs shows that you can find people to buy oil at the lease.

Bruce Frederick

- Issue is whether it is an artificial market or an open, robust market. If open, comparables should work.

Chip Rothschild

- Markets are created all the time.
- But that is the issue--whether it is a real market.

Peter Schaumberg

- There are two viewpoints: (1) the best way to value production is to look at the market; and (2) index value protects MMS and industry from criticism-it's objective and established in market.

George Butler

- Index is just the wrong market. It holds industry to effective standard of marketing downstream.

Sara Tays

- Industry would consider adding a time frame (lock-in period) to prevent gaming.

Valdean Severson

- Would you consider index less transportation and less some marketing cost?

George Butler

- Personally, yes.

Sara Tays

- Spot prices may not be accurate.

Debbie Gibbs Tschudy

- That's not a productive argument; contracts are done on spot price basis all the time.

Fred Hagemeyer

- Important to constituents that comparables be available. Many companies are selling at the lease anyway--so not just a created market for purposes of royalty valuation.

- Not sure how many would actually use the comparables method.

Peter Schaumberg

- Noted that Texaco's tendering percentages are similar to the royalty rate, and that Conoco's are about 10 percent.

Fred Hagemeyer

- Marathon selling over 50% in the Gulf of Mexico.

Peter Schaumberg

- The higher the industry percentage proposed (currently 20%), the more comfortable Interior would be.

Lucy Querques Denett

- What is Wyoming's reaction to MMS's Rocky Mountain Region proposal and the industry proposal?

Mike Geesey/Steve Dilsaver

- Comfortable with the overall concept, but the percentage and the ways you calculate the percentage (sales/purchases) are the real issue. Whatever percentage chosen, it needs to reflect the market.
- Issue of whether to weight purchases and sales differently–impact of large-volume purchase from one company would mean more than buying small portions from multiple sources.
- Sees this as a way for industry to obtain certainty. But may not have certainty if there are questions about how to calculate the percentages.

George Butler

- Under current system, there have been differences in opinion about whether MMS or industry has responsibility to calculate comparables.
- Industry has made concession to agree that it will accept the burden.
- In the interests of doing things contemporaneously, industry would like to be able to calculate value based on its own arm's-length sales.

Valdean Severson

- Questioned percentages as a way to aggregate multiple purchases and sales. Why could, for example, market value be represented by prices for 40 barrels sold by a lessee who produces 200 barrels per day from an field or area with 5,000 barrels per day production, if there are multiple purchases and sales?

- Mike Geesey

- Does this method provide certainty?

4. Binding Determinations

Chip Rothschild

- Industry proposal:
  - -- lessee/delegee can request determination of how regulations/statutes apply to specific situation
  - -- must provide all info
  - -- 45 days for MMS to ask for more info
  - -- 180 days to issue decision
  - -- industry follows its proposed procedure during 180 day period, and if MMS changes policy, it goes back retroactively
  - -- If MMS not timely, then change is prospective only.
  - -- MMS order to modify methodology would be appealble, unless approved at Secretarial level.
  - -- Nothing to prevent settlement agreements
  - -- see specific language in handout
- Noted that 180-day time frame was issue for some at Houston meeting.

Steve Dilsaver

- Was there discussion on State involvement in the process?

Lucy Querques Denett

- We were concerned about the timeframes being short. One reason for concern was need for State involvement.
- Also concerned about finding different factual information later on audit, but having industry argue that the determination is binding.
- MMS and industry to look at IRS and DOT procedures.
- Reengineering will help us to become more current in future, but still could be a loss of revenues before then
- Also concerned about diverting resources from audit strategy to this.

George Butler

- Agreed there would be slight chance of revenue loss. But industry wants policy calls sooner.
- Concern in developing appeals rule was that Department was not always timely in making policy decisions
- This is something to fix the problem

Lucy Querques Denett

- Noted that part of reengineering's intent is to do things quicker, but we need to determine proper procedures first. We agree with the intent, but have concerns about whether we can meet the timeframes.

George Butler

- Need to get issues interpreted. But also desires the valuation determination process to get up-front closure; wants certainty. Perhaps there would be a way to constrain this only to significant issues and not just efforts to lock in royalties on routine matters.

Valdean Severson

- Under RSFA, short appeal time period (33 months) applies.
- Other potential problem is that MMS/State may make decision and later find they did not have all the facts or that the facts are different than originally presented.

Debbie Gibbs Tschudy

- Pointed out that IRS has provisions for such cases.

Chip Rothschild

- Agreed that if original facts later shown to be wrong, decision could be considered null.

Peter Schaumberg

- Noted that some issues may overlap for Indian oil production.
- Also concerned that the industry proposal effectively would compress the 33-month RSFA timeframe to 6 months. Noted that industry is aware of market events unfolding much faster than MMS, thus may have a hard time meeting the time frames with new issues where we may not know all the background market structure.
- May need lots of consultation and review.

Chip Rothschild

- Questioned why, if MMS can't apply its own regulations timely, industry should be at risk. (Concern that industry can be subject to false claims act suits on issues where the Department is unwilling to say how the regulations apply to a situation.)

Peter Schaumberg

- If lessees comply with non-binding MMS guidance, they could not be liable for false claims.

Chip Rothschild

- Companies have been subject to false claims actions when following valuation guidance.

Fred Hagemeyer

- Whether guidance is binding or not, wouldn't the review times be about the same?

Peter Schaumberg

- No; more review time needed at the Solicitor's Office level if the guidance is to be binding.

Lucy Querques Denett

- She doesn't even review guidance–only if precedent-setting. Then it would have to go through her and the Solicitor's Office.

Fred Hagemeyer

- Is there a way of looking at routine vs. precedent-setting matters and imposing different time frames?

Hugh Hilliard

- Concern that appeals process doesn't protect MMS--if MMS approves, it needs to subject the issue to high level of review. If decision binding on MMS, those making decisions would spend additional time and get more review–hence expanded total time.

Sara Tays

- Suggest varying delegations of authority based on importance.

Chip Rothschild

- MMS can just deny the ones it is not sure about, then spend the rest of the 33-month period deciding the issue during the appeal process.

Peter Schaumberg

- But the process proposed by industry may involve more work for MMS and industry.

Chip Rothschild

- Industry has to make decisions whether to appeal within 30 days of MMS decisions.

Peter Schaumberg

- RSFA "fixed" part of this by permitting repayment of royalties plus interest if industry prevails. Concerned now about pinched resources; process could become overwhelmed under proposed methods.

Sara Tays

- Hears that the Department concerned about resource/time problems, and precedential issues. Industry is trying to eliminate retroactivity problems.

Peter Schaumberg

- You could specifically ask for binding determinations and then go through process.
- But then you could end up with long process at IBLA, possibly with hearings, etc.
- Perhaps could be non-binding determinations unless MMS chose to make it binding.

Debbie Gibbs Tschudy

- Not clear why anyone would choose to ask for non-binding determinations.

Chip Rothschild

- All would want binding decisions. If favorable, non-binding decision doesn't protect industry position; if not favorable, wasn't worth asking for anyway.

Sara Tays

- We would like to move ahead and reach agreement prospectively.

Fred Hagemeyer

- It's possible that binding/nonbinding guidance may become a nonissue in the future (after reengineering)

George Butler

- We're trying to put limitations on MMS's discretionary time in dealing with issues. Better to let industry go to appeals process now rather than waiting for audit.

Peter Schaumberg

- If we make up-front decisions, could be viewed as similar to declaratory judgement without benefit of audit.

Lucy Querques

- MMS owes industry information so they can make proper payments; we would like to be more timely. Hopes reengineering will help.
- If we could give binding guidance up front, would help us all. But we don't want to cause problems later on (audit).
- But we also have some concerns about whether this proposal is workable and we plan to look at what other agencies are doing and review ways to shorten our processes.

Valdean Severson

- If we adopt this proposal, proposes that RPC Appeals Subcommittee be reconvened.
- Need to make sure that you can't have determinations that become binding because of missing the timeframes and not having a dollar amount associated with it.
- Concerned because proposal doesn't include State involvement or appeal rights.

George Butler

- Appeals Subcommittee recommended early policy development, but not addressed in Appeals Rule.
- Need to have ways other than Assistant Secretary decisions to establish binding policies.
- Willing to stipulate as to dollar amount.

Peter Schaumberg

- Department will only take issues to the Assistant Secretary for decision ("Blue Star") when record is fairly complete.

George Butler

- Perceives that policy is set by keeping jurisdiction over appeals.

Lucy Querques Denett
- It's rare that we change policy.

Sara Tays

- There may be ways to involve States within the proposed industry 180-day timeframe.
- Up front assessments by auditors could help.

Lucy Querques Denett

- May be able to reprioritize workload by having auditors work with the Royalty Valuation Division up-front concerning valuation determinations.
- But don't want to draw auditors away from audit strategy and have it driven solely by requests.

Valdean Severson

- With small numbers of auditors in States, difficult to divert resources as MMS might be able to do.

Sara Tays

- It is a transition issue; could reduce audit needed at end of process.
- Industry will try to bring in several scenarios on this.

Lucy Querques Denett

- The audit window would be sacrificed as a tradeoff–lose some of the older periods if concentrate on more current issues.

Valdean Severson

- Thought that, in past, Royalty Valuation Division decisions were binding.

Lucy Querques Denett

- No; determinations were subject to audit, and guidance in future would still be subject to audit. And there are more than just facts involved--the environment also must be considered, possibly including incomplete previous data.

George Butler

- If company intentionally misled, that would be fraud/misrepresentation.
- But cited example of FERC tariffs where MMS now won't allow exceptions they previously granted--very troublesome.

Sara Tays

- Troublesome that facts given in good faith and a decision made by MMS, then changed later--not an efficient way of doing business.

George Butler

- Interpreted language of proposed rule to say MMS won't stand behind decisions. Sounds like change to 1988 rules.
- Not trying to get Assistant Secretary to do all valuation determinations.
- Former MMS Director Quarterman implied in last year's meeting with Senator Breaux that authority was never delegated below the Assistant Secretary.

Sara Tays

- Industry will bring several scenarios to the Washington, D.C., meeting April 6.

Valdean Severson

- Didn't understand previous statement by Debbie Gibbs Tschudy that there are really only about 12 valuation determinations each year.

Debbie Gibbs Tschudy

- Described the few cases, among the various industry requests each year, that actually qualify as valuation determinations--for example, they don't include the many requests received for exceptions to the allowance limits and other more "routine" matters.

Sara Tays

- Typically, those cases for which industry wants binding determinations involve high volumes and unique situations. They want certainty to move ahead in such circumstances.

Lucy Querques Denett

- Many such cases won't require audit, but rather significant research.

John Northington
- DOJ business review letter process might also be a corollary.

5. Transportation

Sara Tays

- Historically, MMS has only allowed recovery of capital and O&M for non-arm's length actual costs
- Industry agreed to '88 rules as a compromise only because allowance of FERC tariffs alleviated problem.
- But MMS rejection of tariffs, and a rate of return perceived by industry to be too low,

makes the issue more important.

- Industry doesn't want to debate the FERC jurisdictional issue; instead, thinks would prefer MMS to look to value of transportation service rather than cost--the latter calculation does not capture the full value of the service.
- Proposal based on value of the service provided for non-arm's length transportation:
  -- arm's length comparables (if 20% or more of volume transported on arm's length basis, then use weighted average of such rates for all non-arm's-length shipments through the line)
  -- if less than 20% of pipeline volume transported arm's length, apply modified cost recovery approach: use 2 x BBB rate and set a floor of 10% of original capital cost of pipeline, plus O + M costs.

Peter Schaumberg

- Has industry done any evaluation of how much this would change transportation allowances?

Fred Hagemeyer

- No full analysis done but has done some examples.
- Rate of 2 x BBB does not double the allowance number because that affects only one element of equation.
- Estimate additional allowance of about 15 cents/bbl at the beginning, with smaller yearly increases thereafter.

Sara Tays

- Believes the industry proposal represents a compromise by industry. Thinks the FERC rate is the right rate (much more complicated), but willing to live with this simplified rate.

Fred Hagemeyer

- Notes that both the existing and proposed MMS transportation allowance formulas for non-arm's-length transportation provide a different basis for pipeline owners than for 3rd-party payors.

Valdean Severson

- Industry proposal is similar to its earlier Royalty in Kind cost of service transportation proposal, which New Mexico commented thoroughly and negatively on.
- Would significantly affect royalties on coal seam gas (assuming that the procedure eventually would get transferred to gas). Would cost State money.
- Would allow proprietary pipeline to deduct the full amount of tariff it charges to third party shippers for its own shipments, even though its costs are much less.
- MMS historic position has been based on cost, not value.

Chip Rothschild

- (humorously) By eliminating all transportation allowances, would save more money.

George Butler

- Thinks moving from FERC tariffs to actual cost not appropriate. Disagrees with MMS on FERC process; says FERC is a good judge of rates. MMS's 1994 decision to not permit FERC tariffs viewed as unfair, and we all need to keep working this issue.

Fred Hagemeyer

- Industry believes value of service, rather than cost as defined by MMS, is proper transportation allowance for non-arm's-length situations.

Sara Tays

- Oil and Gas producers may say that oil transportation is just as risky as geothermal development, hence the 2 times BBB rate appropriate.
- Also anxious to get MMS's subsea tie-in guidelines
- Overall proposal supports statutory mandate under OCS Lands Act
- Non-discriminatory (as between those who invested in pipeline and those who did not).
- Need to continue to think about how to solve this issue.

Lucy Querques Denett/Fred Hagemeyer

- Issue of location and quality allowances will be covered in the 4/6 meeting in Washington.

Valdean Severson

- For non-arm's-length transportation for NM, Permian Basin, has MMS or industry considered using spot price at Midland less published tariffs for each leg to get lease crude to Midland? (differentials may vary depending on route used)
- Would help to limit need for data from Form MMS-4415. Trying to eliminate complexities of location/quality differentials.
- Looking at situation from New Mexico viewpoint only, but possibly could be extended across the country.

6. Adjustments for Quality

Valdean Severson

- Do the proposed Federal regulations allow for quality differentials?

Debbie Gibbs Tschudy

- Yes, either through location differentials or through quality bank adjustments.

George Butler

- Wanted clarification on proposed quality adjustments.

John Munsch

- Gravity bank and exchange agreement differentials provided in the proposed rule should provide the needed adjustments.

Sara Tays

- Industry doesn't think sufficient adjustments have been provided in the proposed rule.

John Munsch

- Would an independent have to submit the Form 4415 under the proposed rule?

Debbie Gibbs Tschudy

- Yes, if it had exchanges between market centers and aggregation points and Federal production were involved.

George Butler
- Does the MMS proposal account for additional quality adjustments between the lease and the aggregation point?

Debbie Gibbs Tschudy

- Yes. Additional quality adjustments beyond those that may be part of exchange differentials would be permitted between the lease and aggregation point based on relevant quality bank specifications.
- Gravity banks were created for situations where there were different qualities being mixed together.
- Lessees would only be entitled to value production based on the quality at the royalty measurement point.
- Proposed regulations would also permit lessee to make alternate request of MMS if crude moves to alternate disposal point and lessee doesn't think quality adjustment or transportation allowance appropriate.

Fred Hagemeyer/George Butler/Sara Tays

- We need to look into the quality adjustment process further in the 4/6 workshop.

John Munsch

- Noted that not every pipeline has quality banks.

Fred Hagemeyer

- Further quality adjustment needed from aggregation point to lease where no quality bank exists.

Sara Tays

- Industry has lots of comments on this that it will bring forward at April 6 meeting.

7. Other issues

Valdean Severson

- On industry comparability proposal for valuing non-arm's-length transactions: in determining the 20% comparability, would use comparable crudes only (i.e., sweet vs. sweet, sour vs. sour)?

Fred Hagemeyer

- Generally looking at comparables, but could make some adjustments.
- Needs further thought.

Valdean Severson

- Would the comparability analysis be done month to month?

Fred Hagemeyer

- Probably done on a monthly basis, but could modify to do over longer periods.

Valdean Severson

- Could see how spreadsheet availability as proposed by industry could, at least theoretically, make audit easier for the comparability analysis. But concerned that comparables may not be as simple as it seems.
- On audit might come in and ask for all the contracts, etc.
- What is the meaning of "comparable production areas"?

Sara Tays

- Comparable production areas might represent, for example, fields.

Fred Hagemeyer

- Might be field basis, or maybe lessee-specific; must be clear up front to all involved--proposals on comparability would have been presented to MMS earlier to avoid problems later.
- Might not be large numbers of contracts involved.
- Evergreen contracts might be used, so that contract and formula would stay the same, even if done on a monthly basis.
- Thinks this is much easier than tracing.

Sara Tays

- Industry has to keep all those contracts anyway for gross proceeds determination.

Peter Schaumberg

- We discussed yesterday in Houston the possibility of adding onshore arm's-length sales to those at the lease to do the 20% comparability analysis.

Hugh Hilliard

- Would industry expect MMS approval of "20% comparability" proposals?

Fred Hagemeyer

- Industry thought it would just be presented to MMS so companies could at least get confirmation that they weren't "off base." Would present data to MMS or State as appropriate.

Valdean Severson/Peter Schaumberg

- Field/area determinations would be very important under such a proposal.

George Butler

- How far would you go to get arm's-length sales to use? Further you go, the more difficult audit becomes. Argues that it would be simpler if don't include too many downstream sales, where you have to trace to determine lease price.

Hugh Hilliard

- But the more you exclude such sales, the more it looks like an artificial market at the lease.

Valdean Severson

- How would calls be treated under the proposed rule?

Sara Tays

- Calls shouldn't be compared against index price. Even if calls fall within an arm's-length price range at the lease, MMS would still force noncompetitive calls to index.

Fred Hagemeyer

- Industry doesn't always know whether a call exists, and parties involved often agree to ignore this provision even if it does exist.

Debbie Gibbs Tschudy

- In current proposed rule, MMS removed the previous provision to permit use of arm's-length provisions if (1) a noncompetitive call exists and (2) companies can show it wasn't exercised, because we believed that companies couldn't demonstrate the latter with certainty.

–meeting adjourned-